

Deliveries to NCPA started in 1995 and will continue until the agreement is terminated. Either party has the right to terminate the agreement after May 31, 2014.

Exchange with Tacoma. Since 1963, the Department and Tacoma have coordinated system operations pursuant to an agreement which will remain in effect through October 2003. The agreement provides for the delivery of 37,250 MWh of energy to the Department in August in exchange for the same amount of power in October. Deliveries are shaped uniformly throughout all hours of the respective months. The Department does not expect to renew the agreement when it expires.

Wholesale Market Sales and Purchases

The Department has historically bought and sold energy in wholesale power markets to balance its loads and resources. The amount of energy purchased or sold in the wholesale market has varied with water conditions and with changes in the Department's firm resource base. Prior to 1996, when power available to the Department at critical water levels was roughly equal to its load, the Department typically had surplus power available to sell in the wholesale market when water conditions were above critical levels. With the limitation of its Bonneville purchases in 1996 and the sale of the Centralia Steam Plant in 2000, the Department faced energy deficits at critical water levels, and expected to be a net purchaser of energy in the wholesale market under average water conditions. The Department's new contract with Bonneville, effective October 1, 2001, significantly increased the amount of power available from Bonneville. The acquisition of power from the Klamath Falls Cogeneration Project and the State Line Wind Project further increased the energy resources available to the Department. Demand for power in the Department's service area fell in response to the 2001 rate increases, the Department's encouragement of reduction in usage and the downturn in the local economy. Water conditions were close to normal in the water year beginning October 1, 2001. As a result of all of these factors, the Department had substantial amounts of surplus energy available for sale in the wholesale market in 2002. Sales of surplus power in the wholesale market are expected to continue at high levels over the 2003-2007 period.

The table below displays the actual amounts of energy purchased and sold by the Department in wholesale markets from 2000 through 2002 and the amounts projected to be purchased and sold from 2003 through 2008. In 2000 and 2001, the amount of energy purchased in the wholesale market was substantial due to poor water conditions. The high cost of these purchases reflects high market prices. In 2002, net revenues from wholesale market transactions amounted to \$89.6 million. In 2003, net wholesale revenues are expected to reach \$128.1 million. The net amount of surplus energy available in 2003 is expected to be 7.6 percent below the 2002 level because of less favorable water conditions. However, the effect of low streamflows is expected to be offset by higher market prices. The average price on the Department's wholesale sales is expected to be \$37.08 in 2003, significantly higher than the average price of \$24.27 in 2002. Through June 30, 2003, revenue from sales of surplus energy in the wholesale market, net of wholesale purchases, amounted to \$67.6 million. The Department has secured an additional \$32.1 million of net revenue through forward sales through the end of calendar year 2003. The projection of wholesale market sales and revenue from 2004 through 2007 assumes average water conditions and market prices that average 76 percent of the forward prices for sales at the Mid-Columbia trading hub as of mid-July 2003. Net energy available for sale in the wholesale market is projected to decline from 2004 through 2006 due to load growth in the Department's service area and a reduction in power available under certain existing contracts.

WHOLESALE MARKET SALES AND PURCHASES

	Actual			Projected ⁽¹⁾					
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Wholesale Market Purchases (MWh)	2,571,228	2,411,210	898,613	962,872	33,811	64,660	61,691	53,701	62,074
Cost of Purchases (\$000)	\$212,402	\$518,782	\$23,154	\$36,006	\$973	\$1,860	\$1,596	\$1,673	\$2,006
Average Cost (\$/MWh)	\$82.61	\$215.15	\$25.77	\$37.39	\$28.79	\$28.77	\$25.87	\$31.16	\$32.32
Wholesale Market Sales (MWh)	2,023,060	468,827	4,647,945	4,425,908	4,655,826	4,384,676	3,713,090	3,788,301	3,672,456
Revenue from Sales (\$000)	\$103,082	\$73,899	\$112,796	\$164,105	\$144,997	\$137,230	\$116,695	\$125,981	\$126,561
Average Revenue (\$/MWh)	\$50.95	\$157.63	\$24.27	\$37.08	\$31.14	\$31.30	\$31.43	\$33.26	\$34.46
Sales Net of Purchases (MWh)	(548,168)	(1,942,383)	3,749,332	3,463,036	4,622,015	4,320,016	3,651,399	3,734,600	3,610,382
Net Revenue	(\$109,320)	(\$444,883)	\$89,642	\$128,099	\$144,024	\$135,370	\$115,099	\$124,308	\$124,555

(1) Projections for 2003 reflect actual water conditions through May 31, 2003. Projections for the 2004-2008 period assume average water conditions.

Risk Management

The Department's exposure to risk is managed by a Risk Management Committee ("RMC") consisting of the Superintendent, the Deputy Superintendents for Finance and Administration, Power Management and Generation and the Department's Director of Strategic Planning and Risk Manager. The RMC is responsible for managing both market risk and credit risk.

Market Risk. The RMC meets weekly to review and adjust the Department's near-term and long-term strategy for marketing surplus energy or, in periods of deficit, for purchasing energy to meet load. The Department executes trades in the wholesale market to meet load during periods of resource deficit, to dispose of energy that is surplus to the needs of the Department's retail customers and to optimize the value of the Department's hydroelectric resources by purchasing wholesale energy in off-peak hours, when prices generally are low, and selling energy in the peak hours, when prices are generally higher. The Department does not engage in speculative trading in the wholesale market.

Credit Risk. The Department's Credit Committee, which reports to the RMC, consists of the Deputy Superintendent for Power Management and the Department's Finance Director, Director of Customer Accounts and Risk Manager. The Credit Committee meets monthly to manage the credit risk associated with the Department's marketing activities. Finance Division staff review the creditworthiness of counterparties with which the Department trades power in the wholesale market and recommends credit limits for each counterparty. Where appropriate, credit enhancements are recommended for counterparties that do not meet standards of creditworthiness adopted by the Credit Committee. Finance and Power Management staff monitor trading activity to ensure that credit limits established by the Credit Committee are not exceeded and provide status reports to the Credit Committee.

Transmission

Department-Owned Transmission. The Department operates 656 miles of transmission facilities. The principal transmission line transmits power from the Skagit Project to the Department's service area. In 1994, the Department signed an agreement with Bonneville for the acquisition of ownership rights to 160 MW of transmission capability over Bonneville's share of the Third AC Intertie, which connects the Northwest region with California and the Southwest. The benefits from this investment include avoidance of Bonneville's transmission charges associated with power sales and exchanges over the Intertie and the ability to enter into long-term firm contracts with out-of-state utilities. The Oregon Department of Revenue has initiated litigation to collect a property tax on the Department's capacity rights in the Third AC Intertie. The potential liability is about \$500,000 per year. Summary judgment motions were argued in the Oregon Tax Court in May 2003. An appeal to the Oregon Supreme Court is likely to follow the Tax Court's disposition of the case, and an appeal to the United States Supreme Court is possible.

Regional Transmission Organizations. In 1999, FERC issued its Order 2000, which mandated the formation of regional transmission organizations ("RTOs") and set forth various standards for their organization and operation. In response, Bonneville and nine investor-owned utilities in the Pacific Northwest initiated efforts to create "RTO West," a Washington non-profit corporation, to function as the operator of the principal transmission facilities in the Pacific Northwest and provide transmission services under standardized tariffs. The Department cannot predict the ultimate outcome of efforts to establish RTO West or the potential effects on the Department's operations and finances. See "Change in the Electric Utility Industry."

Transmission Arrangements with Bonneville. Contracts with Bonneville provide the Department with 1,962 MW of transmission capacity under a point-to-point ("PTP") transmission service agreement for the period from October 1, 2001, through July 31, 2025. The Department's rights under the current PTP contract are expected to be preserved under RTO West. However, the rates that will apply to services provided by RTO West are uncertain, as are the rates likely to be charged by Bonneville if the formation of RTO West is delayed or abandoned. In its financial forecast, the Department has assumed that wheeling costs will increase by 22 percent from 2004 through 2008.

Power supplied to the Department by B.C. Hydro under the High Ross Agreement is transmitted over Bonneville's lines under a second PTP transmission service agreement extending through 2005. The High

Ross PTP contract was assigned to B.C. Hydro in 1999. B.C. Hydro in turn reassigned the contract to the British Columbia Power Exchange Corporation ("Powerex"). Under the assignment agreement provisions, Powerex pays Bonneville directly for all costs associated with the PTP contract. The Department expects to renew this PTP contract with Bonneville in 2006 for at least an additional ten-year term, and simultaneously to renew the assignment arrangement with B.C. Hydro for the same term. See "Power Resources—The Department's Resources."

Additional purchases of transmission on a nonfirm basis may be required in the future in order to accommodate the Department's sales of power in the wholesale market during the spring runoff.

Other Transmission Contracts. The Department also transmits power under contracts with Idaho Power for the transmission of power from the Lucky Peak Project, with Avista for transmission of power from the Grand Coulee Project Hydroelectric Authority; with Puget Sound Energy for transmission of power from the Cedar Falls and South Fork Tolt Projects, and with other utilities.

Conservation

The Department has pursued a policy of managing as well as meeting energy demand. As a result of the "Energy 1990" study, prepared in 1976, the City decided to pursue conservation as an alternative to participating in Energy Northwest's Projects Nos. 4 and 5. During the 1980s, single-family residential measures dominated the Department's conservation program. Conservation incentive programs in the commercial, industrial and multifamily sectors were added in the 1990s. Because commercial and industrial measures are more cost-effective, the majority of new energy savings acquired in recent years has come from these sectors, a trend that is projected to continue into the future. Since 1977, the Department has achieved almost 100.4 average MW of energy savings through conservation.

The 2000 Strategic Resources Plan called for the Department to accelerate the pace of energy savings through conservation. In the spring of 2001, a work plan was developed which increased the targeted level of energy savings to be achieved annually through conservation programs from six average MW to nine average MW per year. To meet this higher target, the work plan called for the Department to continue to operate its core conservation initiatives for all customer groups while adding some new programs and services to address service gaps.

The new power sales contract with Bonneville that took effect on October 1, 2001, provides a credit of \$0.50 per MWh against the amounts payable under Bonneville's rate schedules for investments in conservation and renewable resources. The Department estimates that this credit will reduce payments to Bonneville by \$2.2 million per year.

Under a March 2002 agreement with Bonneville, Bonneville has paid the Department \$27 million for conservation savings to be achieved over the period from October 1, 2001, through September 30, 2003. As part of this agreement, the Department's purchases of power from Bonneville under the Block product have been reduced by 9.8 average MW from April 1, 2002, through September 30, 2002, and by 19.1 average MW from October 1, 2002, through September 30, 2011. The Department and Bonneville recently signed a letter of intent to execute an amendment to the March 2002 agreement extending funding for another three years. Under the amendment, Bonneville would provide an additional \$24 million of funding to purchase 7.25 average MW per year of conservation savings over the period from October 1, 2003, through September 30, 2006, with concomitant reductions of 7.25 average MW annually in the Department's purchases of Block power from Bonneville.